THE FINANCIAL REPORTS OF NATIONAL BANKS AS A MEANS OF PUBLIC CONTROL

By F. A. Cleveland, Ph.D.,
New York University

The inquiry suggested by the title would seem to be one of possibility rather than precedent or present practice. Assuming this point of view, discussion will first proceed from a consideration of the law under which powers of control may be exercised. Broadly speaking, there are three legal questions raised: (1) What are the powers of control given by the National Bank Act? (2) Under the Act, what are the purposes for which control is to be exercised? and (3) In the exercise of powers granted by the Act, what devices or means may be employed by the Comptroller to reach these ends?

The Powers of Control given by the National Bank Act.

The first of these questions may be answered by direct appeal to the language of the Act. Section 87 of the National Banking law (Section 5211 R. S.) contains this specific mandatory declaration: "Every Association (*i. e.*, National Bank) shall make to the Comptroller of the Currency not less than five reports during the year, according to the form which may be prescribed by him." This general provision is supplemented by grants of specific power to the Comptroller, which enable him to call for other reports as often as he may desire, and to obtain such information as he "in his own judgment" thinks necessary "to a full and complete knowledge" of financial condition; a bank failing or refusing to comply with such request is liable to a penalty of $100 per day (Sec. 5213 R. S.). It would appear, therefore, that the Comptroller is not lacking in authority to obtain any and all information which may be necessary to administrative supervision. A further reading of the National Bank Act quite as concisely forces the conclusion that the Comptroller has all the power necessary to a complete control over National Banks and their operations, as to all subjects which are properly

within the range of official discretion; this power extends even to the taking possession of the bank itself and winding up its affairs for failure to comply with his demands.

The Purposes for which Control is to be Exercised.

This brings us to consider the second question raised, viz.: the subjects of official discretion, or *the purposes for which official control is to be exercised* under the Act. It has been repeatedly affirmed that the prime purpose of the National Bank Act was to create a better market for Government bonds at a time when the National credit needed support. In the midst of civil strife when the financial resources of the nation were strained almost to the point of bankruptcy it was conceived that a very large part of the capital employed in commercial banking enterprise in the United States might be utilized to support the Government. The plan proposed was an old one—one in which the banks, being induced to use their capital to purchase Government bonds, would be permitted to use bank notes with which to carry on their business. By this device it was thought that the financial strength of the banks might be brought to the support of the Government—*i. e.*, that the State banks might be induced to bring over their capital into a new National system where it might be utilized in the manner indicated.

To make such a scheme acceptable, however, two conditions must be met: The first result of such a plan of support to the bond market would be a large increase in the money circulation of the country; the bank-note would not be received unless it were made as sound (*i. e.*, as valuable) as the money then in current use—the greenback. But this was not the only condition that the Government must reckon with. In the experience of the past, business had suffered quite as much from unsound bank credit in the form of customers' accounts (or deposits) as it had from an unsound currency. National reaction against "wild-cat" banking had but recently forced the several State systems over to a basis of capitalization and official inspection to protect the people against wholesale fraud and bankruptcy. If these State institutions were to be brought into a National banking system—if the Government was to utilize their capital resources to fund its own necessities—the new National system

must carry with it all the provisions for safety and for the protection of the public against the speculative devices of the unscrupulous that three decades of legislative reaction had evolved.

Wild-cat banking was banking on "commercial assets" without adequate capitalization. From 1837 to the time of the Civil War the whole trend in banking ideals and in banking legislation was toward the strengthening of banking equipment. It had been found from bitter experience that a bank which was not properly capitalized, and which therefore did not have capital resources sufficient to support its credit transactions, was as dangerous to those coming into business contact with it as was a mine or a factory whose construction was faulty and whose machinery was overcrowded. To the public, the poorly-equipped bank was much more dangerous than the mine or the factory by reason of the fact that, in case of collapse, a much larger number of people were constantly within the danger line.

After two years of agitation and amendment and compromise an acceptable law was enacted. This Act carried with it two protective features: (1) the note was to be secured by a collateral deposit of bonds purchased, and (2) those holding the credit accounts of the bank were to be protected by provisions which required what was thought to be adequate capitalization before business might be begun, and by the exercise of official supervision to prevent "impairment of capital" during the period that business should continue. It was for the purpose of enforcing these two provisions of safety and security that the Bureau of the Currency was created and a Comptroller was appointed.

Means by which Control may be Exercised, and the Ends of the Act Reached.

The functions of the Comptroller have a direct relation to the conditions above described. The first or, as it was then viewed, *the prime purpose* for which public control was to be exercised was *to guarantee the soundness of the new National currency.* This is clearly expressed in the first clause of the Bank Act which recites: "There shall be in the Department of the Treasury a Bureau *charged with* the execution of all the laws passed by Congress relating to *the*

issue and regulation of a National currency secured by United States bonds; the chief officer of which Bureau shall be called the Comptroller of the Currency * * * ." The *second purpose* of the appointment of a Comptroller is set out in various subsequent portions of the Bank Act designed *to insure adequate capitalization.* These later provisions of two classes, viz.: (1) Those designed to require adequate capitalization as a condition precedent to commencing business, and (2) those intended at all times to secure customers against loss on account of "impairment of capital."

That the "National Currency" which was to be issued through the agency of the banks might be kept as sound as the standard money (*i. e.*, that all forms of money issues might have a common valuation) provision was made that the bonds purchased by the banks might be hypothecated with the Treasurer as collateral security for final payment and redemption of notes outstanding. According to the provisions of the Act the Government was made a trustee for the benefit of noteholders. For each $900 of notes turned over to the bank by the Government for issue, the Treasurer was to hold a non-interest bearing account with the bank secured by a $1,000 bond. The obligation of the bank to the Government was for the repayment of $900 in bank notes, or legal tender money at its own option. The Government as trustee was the legal owner of the bond. The beneficiaries were (1) the noteholders to the amount of notes held, and (2) the bank for the amount of the current income on the bond and for its equity of redemption. This made the bank the immediate agency of redemption of the new currency, and the Treasurer, as trustee, the agent of ultimate redemption. Such a plan of National currency having been adopted, when a bank issued a note the customer took it, not on the credit of the bank, but as a beneficiary in the trust security held by the Government. The noteholder never inquired as to the credit of the bank through which the note was issued, but relied entirely on his claim against the security held in trust by the Treasurer. Since both bonds and greenbacks were Government credit the National currency secured by Government bonds was taken by the public to be as good as a greenback. Later when both greenbacks and bonds were redeemed in gold, this National currency came to be considered as good as gold. As a means of control (to secure the soundness of the circula-

tion or National currency so issued), therefore, the function of the newly created Bureau was to see that the trust account of the bank with the Treasurer was kept amply secured, and that the bonds held as collateral security were sufficient for this purpose. But all the data were at hand for determining this fact, and, the bonds themselves being in custody, the services of the Comptroller in his capacity as guardian of the currency became merely nominal and perfunctory. Moreover, for this service no *report* was necessary.

The Chief Functions of the Comptroller.

Not so, however, with the second function of control exercised by the Bureau—the protection of those who hold open accounts (or deposits) of the bank. The importance of this character of official guardianship has correspondingly increased—but not in its bearing on original capitalization. As at the beginning, the method of ascertaining whether the bank had the requisite capital resources to commence banking operations, has remained one of inspection and not one of financial report. The Comptroller must know that at least 50 per cent. of the amount of the authorized capital stock is actually in hand in money, and that the balance of the stock subscription is good, so that it may be realized in 10 per cent. monthly installments.

The most difficult duty which the Comptroller has to perform and the one of increasing importance to the financial world, is that which pertains to the security of the public against the "impairment of apital resources" *during the period that the bank continues in operation.* Knowledge as to the feature of the work must come largely from the reports made by the banks themselves, as the number of examiners is grossly inadequate to report more than a check on some of the main items of account. It is from this duty that the subject assigned takes its chief bearing.

Protection of the Public Against Impairment of Capital Resources.

To state more specifically some of the questions that the Comptroller must have in mind in asking for reports with respect to capitalization, Section No. 5202 R. S. provides that "no Association at any

time shall be indebted, or in any way liable, to an amount exceeding the amount of its capital stock (capital resources) at such time actually paid in, and remaining undiminished by loss or otherwise, except on accounts of the nature following: (1) Notes of circulation; (2) Moneys deposited with or collected by the Association; (3) Bills of exchange or drafts drawn against money actually on deposit to the credit of the Association, or due thereto; (4) Liabilities to the stockholders of the Association for dividends and reserve profits." Section 5203 R. S. specifies that "no Association shall either directly or indirectly, pledge or hypothecate any of its notes of circulation for the purpose of procuring money to be paid in on its capital stock, or to be used in its banking operations or otherwise; nor shall any Association use its circulation notes or any part thereof in any manner or form to create or increase its capital stock (capital resources)." Section No. 5204 recites that "no Association or any member thereof, shall, during the period it shall continue its banking operation, withdraw or permit to be withdrawn, either in the form of dividends or otherwise, any portion of its capital (capital resources)." Again, in Section No. 5205 R. S. the law requires that "every Association which shall have failed to pay up its capital stock, as required by law, and every Association whose capital stock (capital resources) shall have become impaired by loss or otherwise, shall, within three months after receiving notice thereof from the Comptroller of the Currency, pay the deficiency in capital stock (capital resources) by assessment upon the stockholders *pro rata* for the amount of capital stock (capital liability) held by each."

All of these, and other assignments of duty with respect to the protection of customers against impairment of capital, make necessary an official inquiry into the relation of *capital* resources to *capital* liabilities. They require a specific inquiry as to the capital resources at hand. For the purpose of determining whether or not the capital equipment of the bank has become impaired through "loss" on account of banking operations or "otherwise" a keenly analytical report is necessary. To properly execute this function of control it is necessary to distinguish the *capital* resources and liabilities, from the *other* assets and obligations of business.

The Present Value of the Report to the Comptroller as a Means of Control.

In taking up the "form" of report made by the banks to the Comptroller, attention will be confined to the inquiry as to whether or not it is well designed to give the information necessary to the exercise of sound official discretion. Is the form of report such as to enable one to determine whether the *capital resources* have become *impaired?* An examination of financial statements, as at present made, will disclose the fact that no attempt is made to distinguish "capital" resources and liabilities from the assets and obligations current to the business.

For the purpose of determining financial condition of a going concern, it has become an established principle of analysis that capital resources are all those properties and assets which are intended for permanent or continuous use in the business. Two principles of administration are well settled: (1) To prosecute an enterprise successfully, it is necessary to provide the management with equipment adapted to its purposes; and (2) whatever property, equipment, and stock, is permanently or constantly needed, should be provided out of capital investment. This is the purpose for which capital is needed. Proper equipment is necessary to success. As a matter both of financial advantage and of financial safety, this equipment should be provided out of capital. To attempt to provide permanent equipment out of temporary loans, or floating debt, is to hold the enterprise in constant jeopardy. This is as true of a bank as it is of a railroad or of a mine, and this is the underlying thought of the Law.

The *current assets* of an enterprise are those which are acquired, not for *equipment use* in the business, but those which are acquired in its current transactions—*i. e.*, in the course of current operation for profit. It is to fund the current needs—to meet the current expenses—to provide funds to carry these current assets and transactions—that current liabilities or floating debt is incurred. If the principles of financial analysis commonly employed in accounting are applied to the assets and liabilities of national banks, conclusions may be reached as to whether or not the capital resources have been impaired as well as whether or not the permanent equipment is

adequate to support its operations with safety to those who may be in business contact with the institutions under examination.

What are the Capital Resources of National Banks?

The reports, as at present made to the Comptroller, are not based on such a system of analysis, and, therefore, any attempt at rearrangement to this end must be in a measure unreliable. But taking the various items of resource exhibited as a basis for present discussion, a fair approximation may be reached: (1) "Banking houses and fixtures" are unquestionably capital resources. (2) "Real estate," in contemplation of law and from every point of business reasoning, should be charged against capital. (3) The bank invests its capital in bonds to secure circulation, and receives on the collaterals deposited notes which may be used in the business—the "margin" of capital invested in these collaterals should be considered a capital charge; the same is true of the "margins" invested in the collaterals deposited to secure Government deposits. (4) The "money reserve" is essentially a capital reserve; it is the principal equipment necessary to support the current credit accounts (deposits) outstanding—the floating debt of the business. There can be no doubt that the "cash" held by a bank should be a direct charge against capitalization, and is made so by legal enactment—the only question with reference to this class of items pertains to the interpretation to be given as to what properly constitutes "money reserves." (5) The accounts which it is necessary for a bank to maintain to provide for an "exchange" are likewise an asset permanently needed and in continuous use; they should, therefore, be counted as a part of the necessary banking equipment. (6) Finally the "unencumbered securities" and "other direct investments of capital" owned and held by a bank as a means of strengthening its money reserve should be regarded as capital resource. These must be so considered for the reason that the direct application of capital to the purchase of "securities," or for that matter even the purchase of commercial paper, is not banking. There can be one purpose only for making such purchases, viz.: to keep the capital which is needed to support credit transactions invested in income-producing assets when not needed in the form of "cash." "Securi-

ties" must be considered either as banking equipment, or as an investment which is a charge on capitalization. The same is true of all other direct investments of capital. A bank which engages in buying and selling "securities," in "underwriting flotation" or in other business not in the nature of banking, needs to have a larger capital than an institution which does not so engage itself. Whether the capital investment be in banking equipment, or in other assets and business ventures, the amount of funds thus engaged by the banks should be set up as capital resources, or charges against the capital provided for doing business, the protection of which is the chief end of control.

These several classes of assets being in the nature of capital resources, the relations, pertaining to which the duty of the Comptroller obtains, are to be found: (1) in a comparison of the *capital resources* on hand, with the amount of capital provided for use of the institution under examination; and (2) in an examination of *current assets* to ascertain whether there have been any losses suffered in the prosecution of the business, since all "bad loans," etc., must be charged against capital. The accounts exhibiting capital put into business are found on the liability side of the balance sheet. The capital provided for use is represented in three controlling accounts, viz.: "Capital Stock," "Surplus" and "Undivided Profits." Of these the first two items are permanently reserved for use in the business, and the third must remain in it so long as there is any question as to the impairment of capital resources. Before any comparison may be made for the purpose of determining what character of investments has been made of capital put into the business, the statement of assets reported by the banks must be assumed to be based on a proper valuation, or a critical examination must be had. For this purpose the Comptroller may supplement the report made by the bank itself, with the report of his examiners in whose field the bank lies, or may detail a special examiner if the case seems to warrant such an assignment. In any case, however, a distinction must be made between the current accounts and the capital accounts.

Classification of Balance Sheet to Show Financial Condition.

Intelligent judgment as to the character of equipment provided

by a bank by capital investment requires a *classification of resources.* The exercise of official discretion with reference to the integrity of capital resources which proceeds from the examination of financial reports, makes a *classified balance sheet* a necessity. To the end of establishing a basis for the further discussion of "the financial report as a means of control," and at the same time of showing some of the difficulties which stand in the way of the exercise of effective control under the present form of report, an analysis of the consolidated statement of all the National Banks of the State of Iowa for September 9, 1903, is here exhibited. The classification submitted is not offered as a model in the arrangement of items. Neither is the assignment of inadequacy of the present form intended to reflect on Comptrollers past or present. The form now used is in effect that which has been employed by officers of banks for a century; it has been used by comptrolling officers of government since public examination first began. Suggestion that a change might be made to advantage is not therefore to be considered as offered in the spirit of reflection on official conduct, more than a proposed amendment of law would imply legislative incapacity. Not engaging any spirit of personal criticism and holding in mind my own inability to do more than suggest that a classified balance sheet is essential to further consideration of the topic assigned, the following statement of capital accounts is modestly offered as a tentative and provisional arrangement:

CAPITAL ACCOUNTS.

Capital in the Business.

I.	Capital Stock	$14,881,550
II.	Surplus	3,533,641
III.	Undivided Profits	2,085,923
	Total Capital in the Business	$20,501,114

Capital Investments and Equipment.

I. Banking-house, etc. $2,193,300
II. Real Estate 347,775
III. Margins:
  1. Amount invested in Collaterals:
    (1) U. S. Bonds for Circulation, $8,742,010
    (2) U. S. Bonds for Deposit .. 2,391,100

(3) Other Sec'ties for Deposit	....		
(4) Premium on Bonds (?)	313,006		
(5) 5 per cent. Fund in Treas'y	424,880		
Total Investment		$11,870,996	
2. Less Cash Received:			
(1) Circulation	$8,690,245		
(2) U. S. Deposits	2,324,773		
Total Avails		11,015,018	
Capital Invested in Margins			855,978
IV. Cash Reserves:			
1. Cash Items (?)		$475,136	
2. Bills of Other Banks		481,461	
3. Frac. Currency		36,515	
4. Specie		2,988,269	
5. L. T. Notes		1,498,104	
6. U. S. Certificate of Deposit		....	
7. Due from U. S. Treasury		8,512	
			5,487,997
V. Balances kept with Banks for Exchanges (?)			2,100,000
VI. Unencumbered Securities:			
1. Securities Owned:			
(1) U. S. Bonds on Hand	$18,400		
(2) Stocks, etc.	3,147,380		
Total		$3,165,780	
2. Less Incumbrances:			
(1) Bonds Borrowed	$53,210		
(2) Bills Payable (?)	624,500		
(3) Other Liabilities (?)	79,816		
Total		757,526	
Amount Invested in Unencumbered Securities			2,408,254
VII. Other Direct Investments of Capital:			
1. Loans to Reserve Agents			7,107,810
Total Capital Investments and Equipment			$20,501,114

Attempting to state the amount of capital put into the business, and to account for its investment, in the above exhibit it is assumed that the valuation of assets represented in the reports of the Comp-

troller is conservatively made, and that there are no "bad loans" to be written off. But even with this assumption, and for this purpose, the form of report made by the banks to the Comptroller renders many of the items doubtful: (1) In the statement of "premium on bonds" as one element in the computation of the amount of capital locked up in "margin" there is no way of distinguishing this from premium on "bonds on hand;" (2) In the "cash items" it is of frequent occurrence for banks to include expense vouchers which are to be held till the end of the month; in so far as these were included the statement of the amount of "cash reserve" is too large; (3) the amount stated as "balance kept with banks for exchange" must be roughly approximated as no specific inquiry is made in the present form submitted by the Comptroller to determine this fact—the amount of clearing-house exchanges held is $141,000; assuming that the amount of exchanges outstanding against the banks under consideration averages $175,000, and further, that it requires on an average three days for them to be presented and paid, the average balance needed to be kept for the redemption of exchanges would be $525,000. Assuming again that four times this average amount would place the banks of Iowa in a position at all times to meet exchanges, it would be necessary to carry only $2,100,000 on account with other banks for exchange purposes—this amount is arbitrarily set up; (4) under the head of "incumbrances" on "securities owned" it is assumed that the "bills payable," and "other liabilities," stand as incumbrances on stocks, bonds, etc. This is true to the extent only that these liabilities are based on stocks and bonds hypothecated as collaterals, and in so far as this is not true the account would be varied by an exact return such as might be obtained from the bank; (5) the amount exhibited as "loans to reserve agents" is stated on the assumption that the purpose of such investment is to have a quickly convertible asset by means of which cash may be obtained when the money reserve runs low—a bank making a statement to the Comptroller under a form calling for this specific item of capital reserve might set up some other form of asset as a "direct capital investment." In each and all of the items above mentioned there are elements of doubt—elements which require questions to be raised; but each

of them might be made certain by a different form of inquiry submitted to the banks by the Comptroller.

The Uses which may be made of such an Analysis.

But assuming for the purposes of present discussion that the above analysis of capital investment were true to the facts, let us see what use might be made of such form of report. In the first place we may seek to eliminate those investments which are not in the nature of banking equipment. The building in which the bank is housed is not essentially banking equipment. The banking business is a credit business; primarily, it consists of the exchange of bank credit for commercial credit at a profit. Investment in a building does not strengthen the concern in its current credit relations. Many of the largest banking institutions do not own a building. The prime purpose of capitalization being to provide equipment with which to supply funds to the community in the form of demand credit, any use of capital to purchase a building must be considered as an extraneous investment not available for the support of the credit of a going concern. "Real estate" belongs to the same class of investments. This has been so often said that it has become axiomatic in commercial banking circles. The "margin" invested in the securities hypothecated with the Government is also not available to the business as a going concern. All of the above classes of assets are important as assets for final liquidation, but to a going concern they are purely voluntary and ornamental and bear much the same relation to the business of banking that the gilded dome on the Congressional Library does to the value of its literary stores within. Whether in contemplation of law this amounts to an impairment of capital or not, the fact remains that $3,397,053 of capital invested in this way has weakened the banks of Iowa as going concerns, and to that extent.

Another class of considerations attaches to the remaining classes of capital investments—those resources used to support the banking transactions themselves. Assuming that the banks had made return of redemption equipment as above exhibited, the Comptroller as an agent of the Government should know whether this equipment is adapted to the use for which it is intended. The unencumbered

securities, for example, being intended for an invested reserve to strengthen the cash reserve held to support demand accounts (deposits outstanding), the question pertinent to this use is: "Are these securities immediately convertible by sale or hypothecation without loss of principal?" If, again, any of these are held as the result of underwriting, this fact would suggest that a portion of the bank's capital was being employed in business other than banking and there would be an impairment in use if not in valuation. By some such classification facility would be given to many other official inquiries directed toward the protection of the people against impairment of the capital resources needed by a going banking concern.

A Point of Control not Adequately Covered by the National Bank Act.

While the National Bank Act is very specific as to the powers of control directed against the "impairment of capital" there is another element of banking strength or weakness quite as important that has been neglected, viz.: the protection of the customer against overburdening the equipment used. Judgment as to safety must rest not alone as to the absolute strength of material used in construction and equipment, but this having been determined it must then be compared with the weight or strain to be supported. To be more concrete, every facility is given to such inquiry as the Comptroller may make to protect the capital put into the business against deterioration, but almost no provision is made for inquiry as to whether the credit burden imposed by the bank officers on this equipment in the prosecution of the business is greater than it can safely bear. There is no provision made for correlation of capital equipment with the credit liabilities incurred in the course of the banking business. These obligations must be met on demand, and safety requires that they should be met by capitalization. This is the essential difference between what has been known as wild-cat banking and sound banking as contemplated in the National Bank Act. Banking activities are represented in its current assets acquired and the current liabilities incurred in banking operation. To concretely exhibit this class of financial results, reference will again be made to the summary for the State of Iowa above used in the statement of capital accounts:

ACCOUNTS REPRESENTING BANKING OPERATIONS.

Current Liabilities—Incurred in Banking Operations.

I. Due to Banks and Bankers:		
(1) Due to National Banks	$2,362,481	
(2) Due to State Banks	4,257,426	
(3) Due to Trust Companies, etc	3,258,966	
(4) Due to Reserve Agents	18,377	
		$9,897,250
II. Commercial Credit Accounts:		
(1) Individual Deposits	$58,606,777	
(2) Deposits of U. S. Disbursing Officers	42,586	
		58,649,363
III. Miscellaneous:		
(1) Dividends Unpaid		12,467
Total Current Liabilities		$68,559,080

Current Assets—Acquired in the Course of Banking Operations.

I. Due from Banks and Bankers:		
(1) Due from National Banks	$2,698,877	
(2) Due from State Banks	1,058,729	
(3) Balance due from Reserve Agents	1,483,918	
(4) Clearing House Exchanges	141,352	
		$5,382,876
II. Commercial Assets:		
(1) Loans and Discount	$62,159,426	
(2) Overdrafts	1,121,025	
Total	$63,280,451	
Less Notes rediscounted	105,267	
Net Commercial Assets		63,175,184
III. Miscellaneous:		
(1) Revenue Stamps		1,020
Total Current Assets		$68,559,080

From the two summaries exhibited (the one of "capital accounts" and the other of "banking transactions") it appears that by means of a capital investment of $20,501,114 a banking business of $68,559,080 was carried on. With these results in mind let us determine, in so far as we may from the data in hand, what strain

was brought on capital equipment. In the first place, on what part of the equipment does the banking strain come? As before observed it is at once apparent that no part of the credit strain falls on the first three classes of equipment enumerated, viz.: (1) "Banking house and fixtures." (2) "Real estate," and (3) "Margins." From the point of view of the demands of commercial banking these are purely a gratuitous use of capital. Ownership of a house and furnishings is unnecessary—this paraphernalia may be leased and the rent charged to current expenses, and when a building is owned it is in the nature of a real estate investment; "real estate" owned is an incumbrance on banking capital and not banking equipment; the "margins" invested in bonds used as collaterals for notes and deposits are incidental to the system devised by the Government to strengthen its own credit and as such are not banking equipment—they are a further incumbrance on banking capital.

The equipment necessary to banking transactions is the "cash reserves," or "such invested capital reserves as may be readily converted into cash" and which may be used to meet demands on outstanding credit accounts without curtailing commercial accommodation. As a means of carrying on a business which consists in the exchange of bank "credit accounts" for "income-producing assets in the nature of commercial credit," the bank must establish and maintain a reputation for meeting its credit accounts on demand. The only way that this may be done with safety to its customers is by having capital resources in the form of "cash" when demands are made. The real test of banking strength, therefore, is to be found (1) in the "cash" on hand; (2) in "exchange balances;" and (3) in "unincumbered securities" and "other capital investments" readily convertible into cash. Again assuming the valuation of these capital assets to be conservative, the strength of banking equipment of the State of Iowa by this method of analysis, at the time stated, was $17,104,061.

But a comparison of strength of equipment with the credit strain upon it must be arrived at by bringing the two results together. The total demand obligations for the payment of money were in round numbers $68,559,080. That is, the equipment of cash and immediately convertible capital resources (irrespective of

the commercial assets) being $17,500,000, and the total amount of demand credit to be supported $68,500,000 the inverted pyramid would be $68,500,000\ 17,500,000. But in getting at the amount of the strain that will fall on the capital resources this gross amount must be reduced. Eliminating by set-off the current institutional assets and liabilities the relation of credit outstanding to capital assets employed in a strictly banking business would be $63,200,000 17,500,000. In other words, $17,500,000 invested in banking equipment have enabled the banks of Iowa to purchase about $63,200,000 of interest-bearing commercial assets, by means of about $63,200,000 of their own credit accounts supported by this equipment. The corporations have a gross income about four times as large, through banking operation, as they would have by direct investment of their capital in commercial paper; and they have furnished to the community credit funds which do the work of money equal to about four times the amount of money that would have been in circulation by direct investment.

The purpose of control is to make such a business safe and the differential of safety must be drawn from experience, leaving an adequate margin of protection to the public against contraction of the circulating medium as well as protecting customers against immediate loss from non-payment. The need for a better correlation of capital resources with banking operations carried on, may appear the more vividly by comparison of the several classes of banks reported:

COMPARATIVE RESULTS OF ANALYSIS OF DIFFERENT CLASSES OF NATIONAL BANKS, SEPTEMBER 9, 1903—STATED IN MILLIONS OF DOLLARS.

Classes of Items	All National Banks of the United States	Banks of Reserve Cities	Banks of St. Louis	Banks of Chicago	Banks of New York	Banks of Central Reserve Cities
CAPITAL RESOURCES						
Banking House, etc.	$107	$ 25	$ 1.2	$ 1.3	$ 20	$ 23
Real Estate, etc	21	4	.1	.2	3	3
"Margins"	58	13	1.0	.6	15	17
Cash Reserves	$606	$147	$18.4	$42.7	$177	$248
Exchange Accounts (?)	40	16	4.5	....	....	....
Securities	478	116	3.3	....	....	....
Other Direct Capital Investments	....	....	2.4	....	....	....
Total Capitalization*	$1,310	$321	$30.9	$44.8	$215	$291
CURRENT ASSETS						
Cash	....	....	....	$ 5.5	$ 32	$ 27
Securities	....	....	....	11.9	79	95
Due from Banks	$ 930	$ 321	$ 12.1	70.0	144	233
Commercial Assets	3,462	893	89.6	181.5	632	902
Total Current Assets and Liabilities	$4,392	$1,214	$101.7	$268.9	$887	$1,257
CURRENT LIABILITIES						
Due to Banks	$1,226	$460	$54.9	$143.3	$436	$634
Commercial Credit Accounts	3,166	754	46.8	125.6	451	623

*Capital Stock, Surplus and Undivided Profit.

In so far as may be determined from the bank returns made on the form now used, the foregoing summary shows the disposition of capital invested in the banking business in the various classes of banks represented. From this it would appear that, while in a single agricultural State like Iowa the banks, as a whole, by their own capitalization have provided the equipment used to support their outstanding credit, taking all of the banks of the United States, they have provided no capital for direct investment in "loans to reserve agents," and aside from the "cash reserves" have provided scarcely enough for adequate "exchange accounts." The banks in reserve cities are in about the same relative condition as those of the country at large. The banks of the central reserve cities, however, have not sufficient capital to provide themselves with the current "cash reserves" used in the business, and which are required of them by statute. At the date of making the report the amount of "cash" provided through capitalization by this class of banks

was only 24.2 per cent. of the net banking liabilities; the balance of the amount of "cash" on hand to support outstanding accounts, and to meet the 25 per cent. legal requirement had been borrowed.

Judgment of Bankers as to whether Present Capitalization is Adequate.

If, on the other hand, we take the judgment of bankers as to what equipment is necessary to the safe conduct of their business, another result will be obtained. For this purpose it may be assumed that a banker will keep no more "cash" on hand than safety to his business requires; if he does he is violating good business judgment. The same may be said of "exchange accounts" and of investments made in low income-producing assets from which "cash" may be realized by quick turns to support credit accounts. Assuming further that the principle is a sound one, that such assets as are permanently employed, or are continuously needed in the business, should be procured by direct investment of capital (*i. e.*, that a business concern, especially a bank, should not obtain its equipment on a "floating debt"), then the inadequacy of capital measured by the standards set by bankers themselves increases as we proceed from periphery of the National Banking system towards this center. To exhibit this in tabular form, the result of failure of the law to require such control as will prevent the overtaxing of capital resources, and such as will insure that our commercial banks do business on their own capital, would appear something as follows:

COMPARATIVE STATEMENT OF EQUIPMENT ACTUALLY USED BY THE SEVERAL CLASSES OF BANKS—STATED IN MILLIONS OF DOLLARS.

Classes of Capital Items	Iowa	Country Banks	United States	Reserve Cities	Central Reserve Cities	New York
CHARGES AGAINST CAPITAL						
Banking House, Real Estate, and Margins	$ 3.4	$ 101	$ 186	$ 42	$ 43	$ 38
REDEMPTION EQUIPMENT USED						
Cash Reserves	5.5	183	605	147	275	208
Exchange Account	2.1	120	187	46	21	14
Securities	2.4	260	470	116	94	79
Loans to Reserve Agents	7.1	153	267	114	......	....
Total	$20.5	$817	$1,715	$465	$433	$339
Capitalization	$20.5	$698	$1,310	$321	$291	$215
Floating Debt	......	119	405	144	142	124
Percentage of Floating Debt	......	17%	31%	44%	49%	58%

In the above, question is raised as to several classes of items. Without specific inquiry in the form of report required as to the amount which a bank carries for "exchange accounts," this must be approximated. The approximation here given, however, is a deduction from "Loans to Reserve Agents" (another account which is carried as an invested reserve for the purpose of supporting the cash reserve) and, therefore, one which should be capitalized. As to the "securities held," in so far as they are not held as reserve equipment, they are not a banking resource and like "real estate" are in the nature of an encumbrance on banking capital. Such assets must be either for support to bank credit or for direct investment. In either case the bank should not buy bonds on credit. Taking the charges against capital as they stand and the redemption equipment actually used, we find that for the United States, in the judgment of bankers themselves as reflected in practice, the banks should have provided $405,000,000 more of capital to support their business. That is, to properly support $4,392,000,000 of credit used in the course of bank operations to purchase $4,392,000,000 of income producing assets, the equipment which was actually used should have been provided by the proprietors of the business. Such a provision would require an increase of 31 per cent. in total bank capitalization. But further inquiry would show that all but 9 per cent. of this gross amount would be required of the reserve cities, and that a very large portion of the increase is needed in the city of New York.

Inadequacy of the Reserve Requirements.

Again I wish to affirm the position before taken—that this is not proposed as a true method of analysis to get at the relation of intensity of credit strain to equipment used. Attention is directed to the fact only that such an element should be taken into account in reports, the purpose of which is to furnish the data for official control. Further, it is suggested that no provision is made in the present form of report for ascertaining these data; and only one provision of law is made to protect the public against any overtaxing of capital equipment. This one provision referred to is the clause which imposes a minimum limit in money reserve to be

kept. Drawing on experience and on the expression of banking opinion in legal form in State practice before adoption of the National Bank Act, the minimum money reserve to be kept by country banks was set at 15 per cent. of credit accounts outstanding, and for reserve city banks, 25 per cent. This clause was modified, however, under pressure from the banks, so that in estimating the amount of cash on hand three-fifths of the 15 per cent. money reserve of country banks might consist of loans to reserve city banks, and one-half of the money reserve required of reserve city banks might consist of loans to central reserve city banks.

This limitation imposed does, in fact, operate to prevent some of the least provident bankers from bringing their houses down on the heads of customers, and precipitating a panic in the business community. Nevertheless, the provision is entirely inadequate to prevent an overtaxing of equipment. To illustrate one of the methods used for complying with the law and at the same time for carrying a load that keeps the institution on the verge of credit collapse: From the published reports it appears that a number of banks have individual deposits outstanding amounting to from ten to twelve times their capitalization. Some of these banks continuously carry a cash fund larger than their capital stock, surplus and undivided profits. Where did they obtain this money? Undoubtedly they borrowed it. In several instances, only about one-third of the equipment constantly used by these banks is provided by means of capitalization; the balance is obtained on demand loans. Imagine another enterprise being financed in this manner!

The Present Condition not the Fault of the Banker but of the Bank Act.

I am not finding fault with a bank for doing business in this way. If a banker finds that he may obtain capital from others with which to do business and that, when a sudden demand comes for payment, he can force his commercial customers to find the means necessary to replace the temporary foundations withdrawn, if by such methods the banker may be able to keep his own house from falling on the heads of managers and stockholders, he may be exonerated on the principle that he has availed himself of a business

advantage which has brought a large return in profits. But the purpose of control is not to protect the bank. From the point of view of the purpose of public control we ask the question, "What is the result of this character of banking to the commercial community?" As a national system this is simply another form of wild-cat banking and it is in this very practice that we find much of the trouble that heretofore has been ascribed to inelasticity of the currency. The prime fault is in a law which permits bank capitalization inadequate to maintain the volume of bank credit offered to the community with which to do business and of which customers have availed themselves. This being suddenly withdrawn to protect the bank from its own weakness, the community is left in a crippled condition to shift for itself.

One of the purposes of control should be to secure a better co-ordination between the volume of credit accounts sold and capital equipment provided as a means of support; to this end the National Banking Act needs revision. But having been revised so as to give the Comptroller power to exercise supervision to prevent the over-straining as well as the "impairment" of capital equipment, the present power to compel reports is sufficient to make this supervision effective. One of the two principal purposes of the Bank Act is to guard the integrity of our financial system and to protect the public against loss on account of inadequate capitalization. To effect the full measure of good intended by the Act, to vouchsafe a system of control which will secure "sound banking" as well as "sound currency," there should be added to the present powers which are intended to protect against an impairment of capital, inquisitory powers directed against an overloading of equipment. As a means of executing this authority, classified schedules should be devised which will furnish the information necessary to intelligent official discretion, and classified financial statements of results should be published, that the public may the more intelligently deal with the banks.